ASIA SECURITIES FORUM COUNTRY REPORT

Country: New Zealand

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1. EXECUTIVE SUMMARY

New Zealand's economy is expected to grow at an annual pace of 3.5 percent over 2016.

Global growth is below trend despite being supported by unprecedented levels of monetary stimulus. The prospects for global growth and commodity prices remain uncertain. Political risks are also heightened.

Weak global conditions and low interest rates relative to New Zealand are placing upward pressure on the New Zealand dollar exchange rate. The high exchange rate is adding further pressure to the export and import-competing sectors and together with low global inflation, is causing negative inflation in the tradables sector. A decline in the exchange rate is needed.

Domestic growth is expected to remain supported by strong inward migration, construction activity, tourism, and accommodative monetary policy. However, low dairy prices are depressing incomes in the dairy sector and reducing farm spending and investment. High net immigration is supporting strong growth in labour supply and limiting wage pressure. House price inflation remains excessive and has become more broad-based across the regions, adding to concerns about financial stability.

Headline inflation is being held below the target band by continuing negative tradeables inflation. Annual CPI inflation is expected to weaken in the September quarter, reflecting lower fuel prices and cuts in Accident Compensation Corporation levies. Annual inflation is expected to rise from the December quarter, reflecting the policy stimulus to date, the strength of the domestic economy, reduced drag from tradables inflation, and rising non-tradables inflation. Although long-term inflation expectations are well-anchored at 2 percent, the sustained weakness in headline inflation risks points to further declines in inflation expectations.

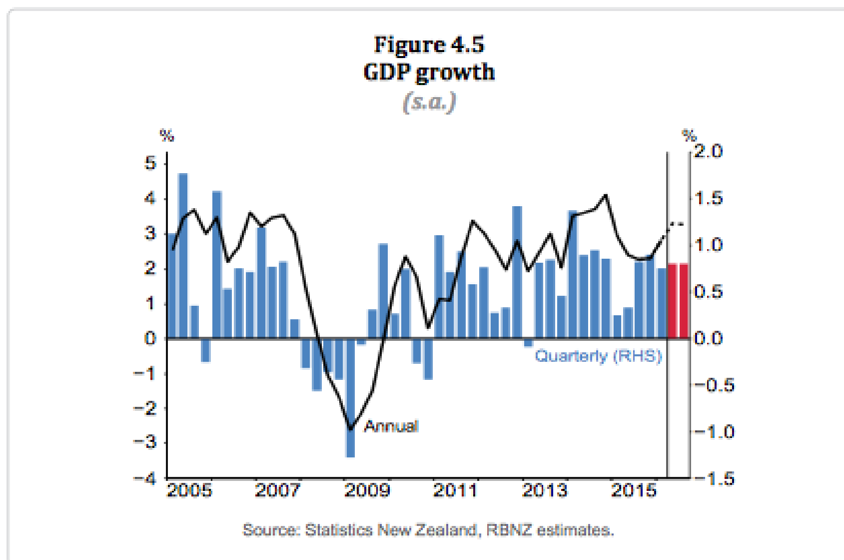
With regard to New Zealand securities, equity markets valuations are at the upper end of the scale but yield based stocks continue to be supported. Earning yields remain attractive to bond yields by a significant margin. Demand for sovereign bonds is being driven by our relatively high positive yields which in turn is maintaining a relatively high currency.

2. THE NEW ZEALAND ECONOMY

Leading indicators suggest a near term annual GDP growth rate of around a robust 3.0-3.5% year on year. Current supportive factors include:

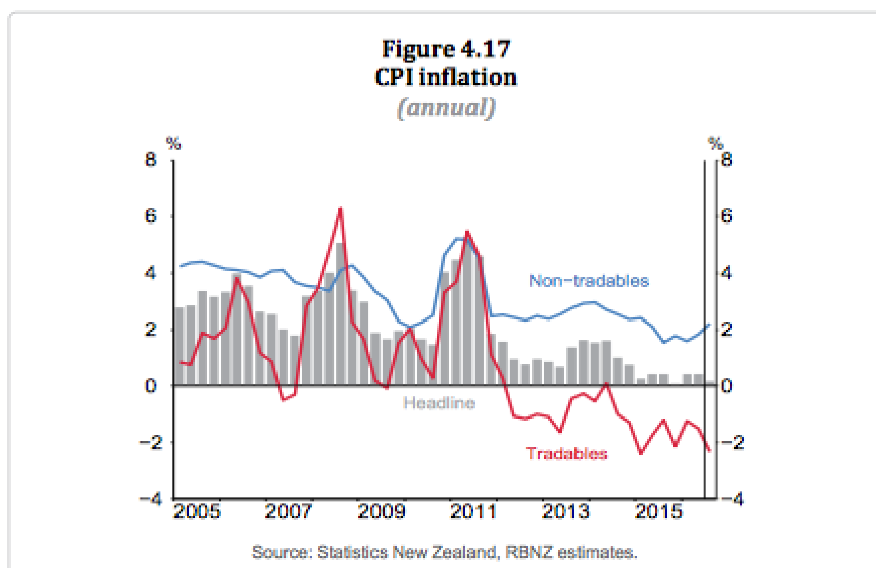
- Historic high migration
- Strong tourism growth
- Robust construction sector activity both in residential housing and infrastructural spending

- Historically low interest rate setting environment



Current negative factors include:

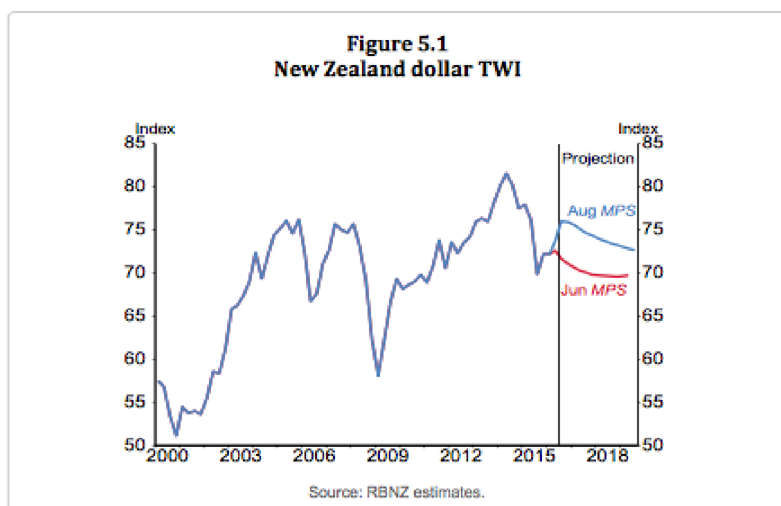
- Domestic growth weaker on a per capita basis
- Strong migration inflows creating stresses in the economy
- Excessive house price inflation in Auckland and across the major centres increasing financial stability risks
- Dairy prices continuing to remain below average
- NZ dollar exchange rate remains elevated due to relatively high yields impacting on export competitiveness
- Slow global growth and a risk of rising global protectionism

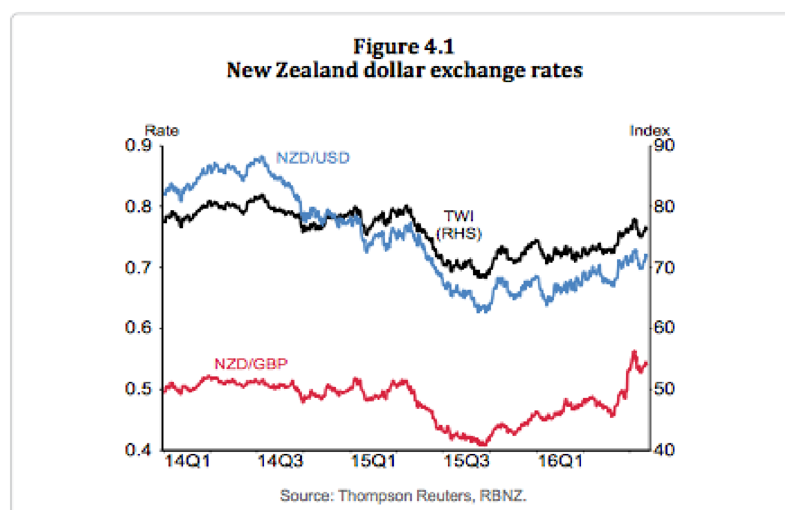


As inflation pressures remain muted the Reserve Bank retains an explicit easing bias. Weakness in tradables inflation is providing for subdued expectations which will maintain CPI Inflation well below the 1-3% Target Band. Short term inflation expectations have fallen below the midpoint of the target range following

observed low headline inflation. Inflation expectations appear well anchored. Long-term inflation expectations continue to be close to 2 percent and are expected to remain around this level.

The NZ Dollar remains stubbornly strong largely due to strong demand for high yielding New Zealand Dollar investment assets. The Reserve Bank comments that "a decline in the exchange rate is needed". The New Zealand dollar Trade Weighted Index (TWI) is assumed to depreciate gradually to 73, as global conditions improve and policy rates overseas increase closing the differential between the return on the New Zealand dollar and foreign currency assets.





Recent monetary policy decisions include the lowering of the OCR by 100 basis points through 2015. Accounting for the projected forward path of interest rates, the downward revision was considerably larger at around 200 basis points, as the Reserve Bank moved from a tightening to an easing bias driven by declining global economic conditions. In March 2016, the Bank cut the OCR by a further 25 basis points and since that time inflation expectations have remained stable.

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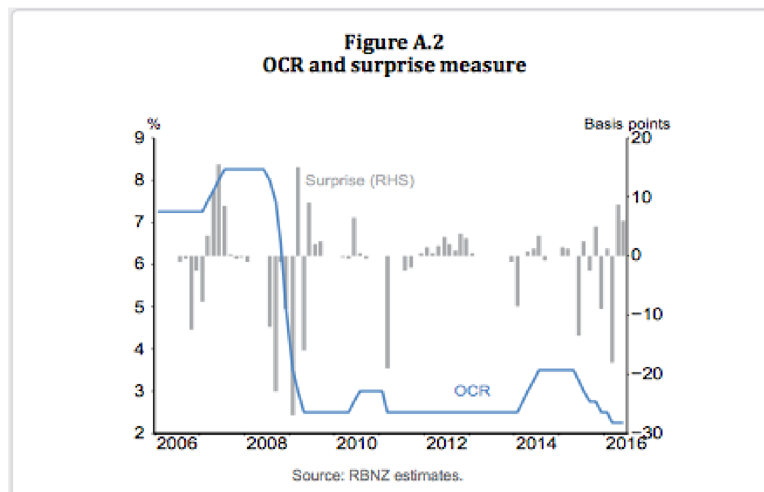
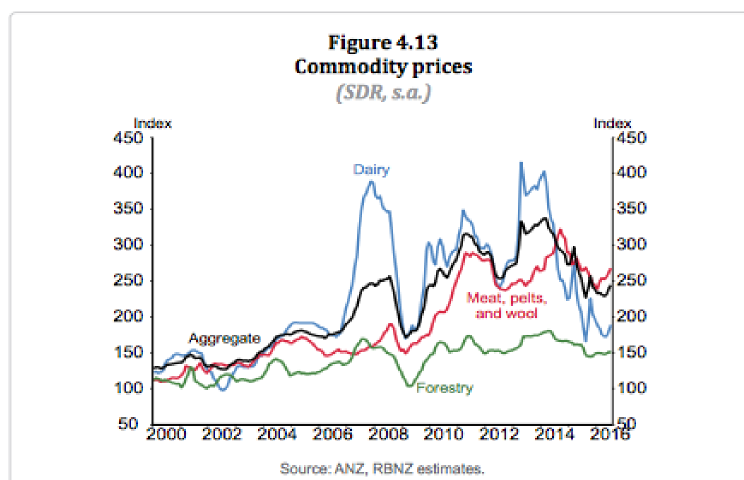


Key economic risks to the NZ economy include:

- A slower growth profile – particularly in China and East Asia
- Financial market uncertainty & volatility surrounding the Fed tightening profile
- US election uncertainty that may impact on credit markets
- A sharp change in migration flows

Major financial stability risks include:

- Additional weakness in dairy commodity prices, aggravating elevated dairy sector debt
- Excessive Auckland house price inflation increases the risks of a sharp correction
- Disruptions to global funding markets caused by a multitude of risk factors including elections, debt defaults or geo political events.

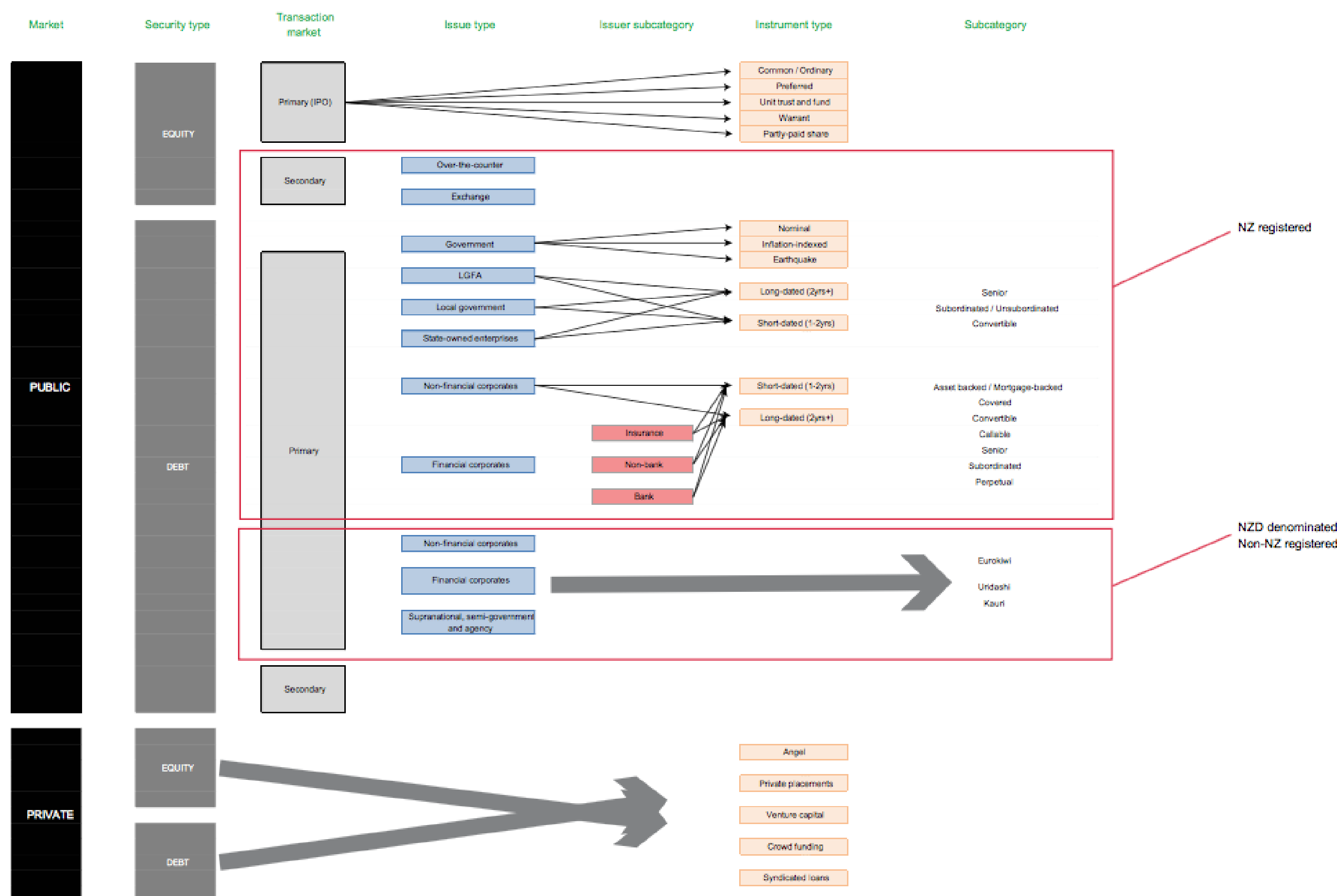


As such any pronounced softening in domestic activity can be expected to result in a more aggressive easing in monetary and potentially fiscal policy settings.

3. THE SECURITIES MARKET

New Zealand's debt market has traditionally been dominated by government issues, followed by the larger banking institutions issuing bonds into both the wholesale and retail markets. Similarly, the top 10 companies on the share market represent 54 percent of the value of the NZX 50, with the top two companies making up a third of this alone (18 percent of the overall index). However, in recent years, New Zealand's capital markets have become more diverse with crowd- and peer-to- peer funding a growing phenomenon, and the market has deepened as the pooling of assets has become more common; for example, in the developing covered bond market following the formation of the Local Government Funding Agency (LGFA). By contrast, smaller firms tend to obtain external financing from family or friends or from financial institutions (typically from the banking system). The regulatory and accounting requirements are often considered too onerous and expensive for smaller firms, discouraging them from public market issuance of both debt and equity – although recent regulatory reforms have lowered the disclosure and compliance costs for smaller firms in these markets.

A stylised representation of the structure of capital markets in New Zealand



New Zealand's listed equity market is small by international standards. Stock market capitalisation is 40 percent of GDP, less than half that of Australia but similar to that of China and Germany. However, given New Zealand's low national savings rate, a high proportion of large New Zealand companies being wholly-owned offshore, and a relatively low capital-intensive economy, a small listed equity market is perhaps not surprising.

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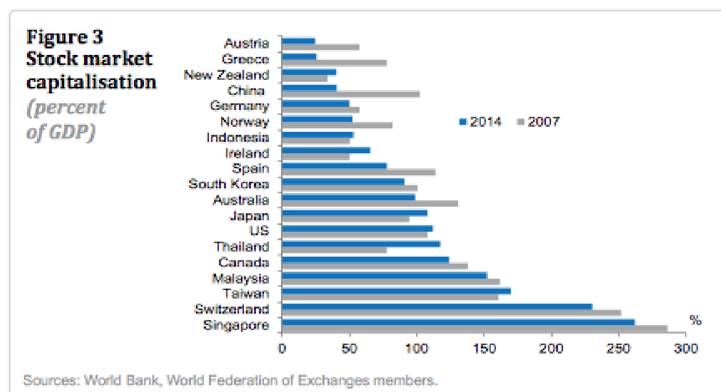


Primary issuance in the New Zealand share market has increased over the past two years, from an average rate of 5.4 initial public offerings (IPOs) per year from 2003 and 2007 (inclusive) to an average of 10 in 2013 and 2014. There has been a greater proportion of domestic investors (domestic holders excluding government) owning shares at the point of an IPO, rising from 54 percent in 2004 to 67 percent in 2014. Part of the recent surge followed the partial privatisation of a number of government-owned utility companies.

Over the past decade, domestic institutional holdings of primary listings increased nine percentage points to just over 40 percent of ownerships. The emergence of the KiwiSaver scheme in New Zealand may explain some of the uptick in recent years, although as Henry, Aitken, and Koreman-Smith (2015) point out, domestic institutional ownership still remains low compared with many other countries, including Australia. Activity in the secondary market has also increased, with the number of transactions on the NZX 50 increasing from 319,000 in 2010 to 862,000 in 2014 and the number of shares traded rising from 2 billion in 2010 to 3.4 billion in 2014. In general, greater turnover increases market liquidity.

In recent years, a number of innovations and changes have occurred that may have assisted in both the growth and increased turnover of the domestic equity market. The Financial Markets Conduct Act is designed to support the capital market regulatory environment and simplify issuance by smaller firms. The particle privatisation of SOEs has likely raised the national and international awareness of the domestic stock market, at lease for a time. Tax changes in 2010 may have encouraged the share of new investment going into non-financial investments (e.g. property) to have fallen at the margin. And as noted above, the KiwiSaver scheme has contributed to an increase in the demand for domestic equity in portfolio holdings. Finally, timing may well have played a part. Historically low interest rates and an upward sloping yield curve may have encouraged investment into capital markets (both bond and equity), and the appreciation and outperformance of the share market since 2012 may have increased the public's awareness via the media and news articles.

Issuance of bonds in New Zealand can be separated into a number of categories, these include central government, local government, SOEs, financial companies and non-financial corporates. Non-resident entities also issue bonds into the NZ market and these are known as Kauri bonds.

As of October 2014 about $121 billion of outstanding bonds had been issued by New Zealand resident entities into the local public debt market, which amounted to just over 50 percent of GDP. The majority of resident-issued debt ($73.5 billion) was in the form of central government bonds. In addition, there were $19.1 billion of Kauri bonds outstanding that had been issued in New Zealand by non-resident entities.

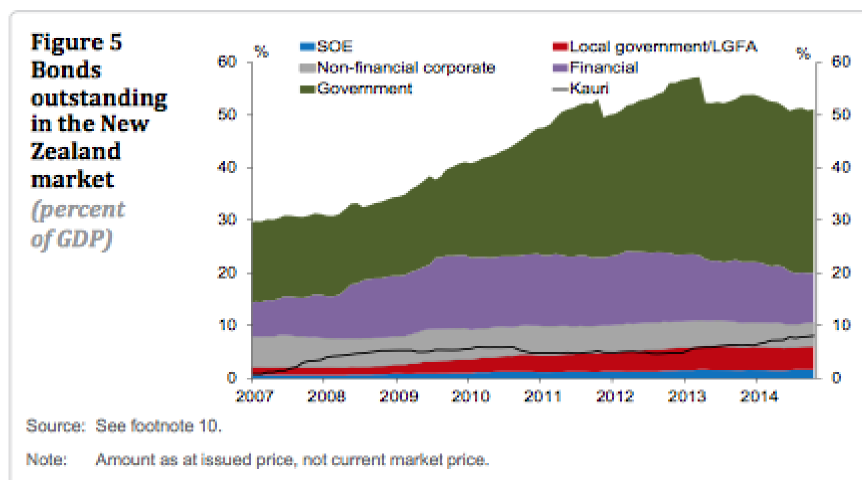


Figure 5 Bonds outstanding in the New Zealand market *(percent of GDP)*

Source: See footnote 10.

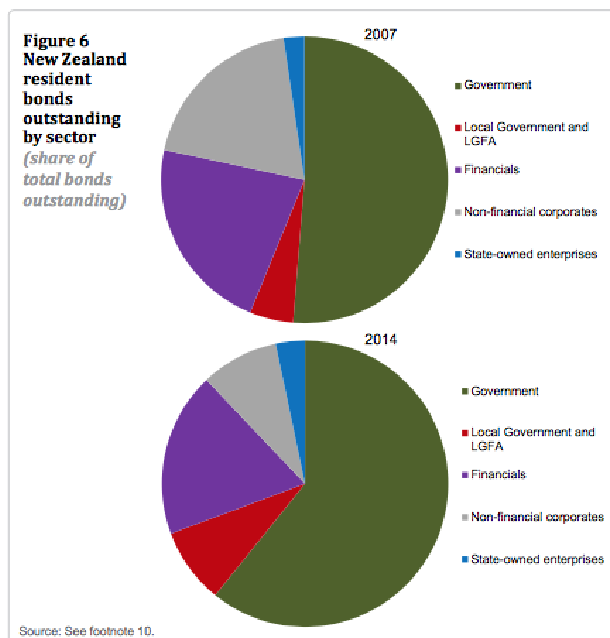
Note: Amount as at issued price, not current market price.

The total amount of bonds outstanding in the local market (excluding Kauris) has more than doubled since 2007 in nominal terms, rising from just over $50 billion (30- percent of GDP) at the start of 2007 to $121 billion. More than two-thirds of this rise is due to an increase in central government debt, while nearly 20 percent of the increase represents bond issuance by banks. The increase in government bond issuance is linked to the shift from fiscal surpluses to deficits during the GFC, and further issuance following the Christchurch earthquakes.

New Zealand bank increased their issuance of long-term debt sharply in the immediate post-GFC period. This followed from a number of changes in the global environment, including the risk of a negative credit rating from international rating agencies stemming from a reliance on short-term funding, a lack of global liquidity, and a cessation of some wholesale funding markets during the depth of the FGC (increasing the risk of a failure to roll over upcoming funding needs). In addition, New Zealand registered banks are now required by the Reserve Bank to raise a greater proportion of funding that is likely to remain in place for at least one year, as part of the prudential liquidity policy introduced in 2009. The Reserve Bank's prudential liquidity policy was implemented to reduce the risk posed to New Zealand's banking system by an overreliance on short-term wholesale market funding.

As at October 2014, the New Zealand (central) government sector had issued 61 percent of New Zealand's bonds outstanding. By comparison, the share of the local government sector was 8.5 percent, with 18.5 percent issued by banks or other financial institutions and 9 percent by non-financial corporates. SOEs comprise the remaining 3 percent. This breakdown has changed markedly since 2007; as previously noted, central government debt makes up a much larger share today, while the proportion of non-financial corporate bonds has fallen from 19 percent to its current level of 9 percent of the total. Although the nominal amount of bonds outstanding has increased for all sectors, non-financial corporate bonds have decreased as a share of GDP, falling from 5.7 percent to 4.5 percent currently (possibly reflecting weaker overall demand for business credit in the past five years). Note that figure 6 does not include bonds issued by New Zealand entities in offshore markets; if included, the share of government bonds would decrease.

To give some context to the overall size of the domestic bond market, Laeven (2014) reports that total private-sector domestic debt securities (i.e. excluding government and local government) for high-income economies averaged 33 percent of GDP in 2010. By comparison, the equivalent figure for New Zealand was around 20 percent of GDP in 2010. Furthermore, as a funding source for New Zealand non-financial firms (i.e. SOEs and non-financial corporates), debt outstanding (as at October 2014) was $14.6 billion. By contrast, credit provided to non-financial firms (including the rural sector) by the banking system amounted to $137 billion as at September 2014. In addition, many large New Zealand companies are wholly owned foreign firms. These firms will often have some funding (debt) provided by the offshore parent.



a. EQUITY MARKETS OUTLOOK

New Zealand's equity market valuations remain full but yield based stocks remain supported. Domestic market valuations reflect 12M forward core PE's of 21.2x with a long run average of 16.3x. NZ equities have been supported by relatively attractive GDP growth, low domestic interest rate settings and a relatively high yield. The domestic macro environment is expected to show growth averaging around 3.3 over 2016. Muted inflation is expected to prompt lower interest rate settings and a likely modest depreciation in the NZ dollar. Lower short term interest rates are expected to offer support for yield stocks, however high single digit earnings per share growth is expected to come under pressure.

Key macro risks to the equity market in NZ include further commodity price weakness, a sharp NZ housing market correction and global risks including a hard landing in China, central bank policy surprise and an abrupt change in financial condition.

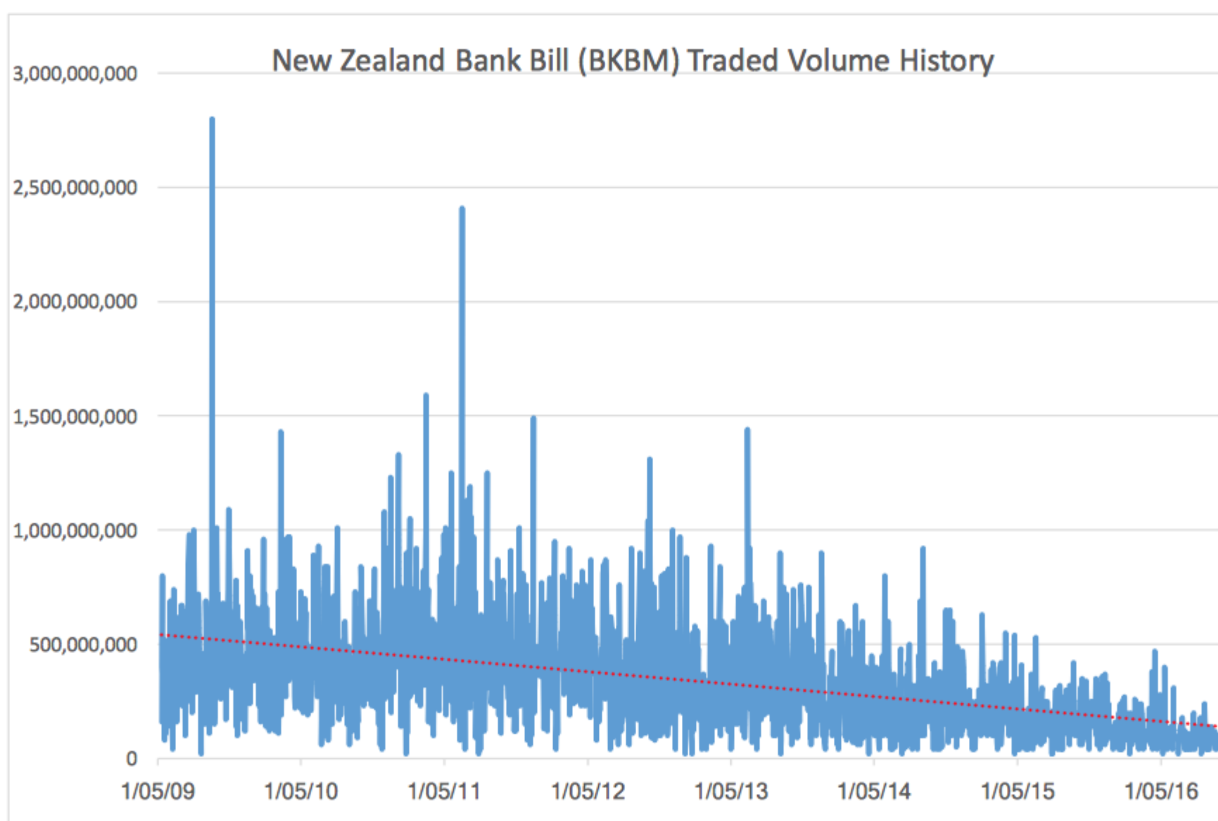
b. BOND MARKETS OUTLOOK

New Zealand is a politically stable economy with a fiscal situation is the envy of many of the major economies around the world. The recently announced budget surplus and relatively low levels of public sector debt at 30% of GDP added to high relative gross and net bond yields, make our bond market highly attractive to global investors.

4. INDUSTRY ISSUES RELEVANT TO THE NZFMA

a. Bank bill transactional liquidity

A key part of the NZFMA's role in the New Zealand Financial markets is to perform both the Benchmark Administration and Calculation Agent functions for the key financial reference rates. New Zealand's IBOR rate is derived from trading in bank bills that reflect the unsecured lending rate between banks operating in this market. Current uncertainty relating to what constitutes acceptable trading conduct in this market has led to a significant decline in liquidity threatening the NZFMA's ability to maintain a robust and accurate rates set.



In order to reverse this trend, the NZFMA has been liaising with both the Reserve Bank and the Conduct Regulator, the Financial Market Authority with the view to providing certainty with regard to what does constitute acceptable conduct.

b. Closing rate project

Most financial markets jurisdictions are experiencing submission reluctance from panel banks to financial benchmarks and market closing rates. This is driven generally by regulatory risk aversion relating to the large fines imposed on some panel banks submitting to key benchmarks including Libor & Euribor. In the New Zealand market, we are very dependent on `Closing Rates' to promote secondary market activity, offshore investor confidence and to support revaluations of both retail and wholesale investment portfolios. Due to dwindling submission support from local panel banks the NZFMA has embarked on a project to scrape executable bid/offer quotes from Bloomberg live quote pages, submitted by member

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banks to establish closing market rates without the need for bank `expert judgement'. This project will solve the submission risk aversion issue and is expected to be completed by year end 2016.

c. **Cross border regulation**

i. **Benchmark equivalence**

The move by European and US based regulators to regulate benchmark activities have significant cross border implications. In the case of proposed benchmark regulation by ESMA, other regulatory jurisdictions will need to comply with the European requirements or be faced with their benchmark and related derivatives being blacklisted where a European counterparty is involved.

ii. **Margining of uncleared derivatives**

With the global move to the central clearing of derivatives, prudential regulators are moving to update margining requirements for those derivatives that are not centrally cleared in order to reduce systemic counterparty risk. In the case of Australia, APRA the prudential regulatory has introduced law changes that will impact on New Zealand subsidiaries and branches of Australian Banks that may not be enforceable or introduce legal ambiguity under New Zealand's law.

These are just two examples of cross border regulation impacting on NZ's Financial Markets. Many more examples can be found.

Ends

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